DrobnyGlobalMonitor

July 25, 2013

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Biases:

EQUITIES: Bearish Major Country (non peripheral Eurozone) Equities
BONDS:
FX: Bearish Yen
EMG: Bearish Asian EMG interest rates;

Current Exposure:

EQUITIES:
BONDS: Long 5yr BTP vs 5yr Bund (July 8);
FX: Long KRW vs JPY (July 11);
CMOD:

2013 NYC Macro Summer School Review

****Please note latest changes to biases and/or exposure***

This was the inaugural BNP/Drobny Macro Summer School, designed to give younger professionals exposure to how top HF veterans think about and approach markets. The discussions were lively and, as is typical of Drobny events, specific trades sneaked into the discussions as examples of how the veterans actually trade the markets.

Some basic themes emerged through the day. Virtually all presenters emphasized the importance of sizing trades appropriately and, if anything, making them smaller than you might initially think. That allows you to avoid having to reduce exposure at inopportune moments and gives opportunity to countertrade when volatility increases. Additionally, the traders repeatedly warned about what one called 'hedgehog' behavior, putting your head in the ground and sticking to a view/position. Instead, many urged to look for disconfirming evidence and to always question your views. Participants were repeatedly urged to view every trade in their portfolio as a new trade each morning, and to consider any new news that has emerged, whether they would still put it on that day in the same size, and if not to adjust accordingly. There was a lot of wisdom that flowed during a busy day!

I provide below a review of the main presentations. Please be aware that this is my own review of the proceedings. Comments, questions, critiques, additional ideas are welcomed and encouraged.

1) Michael Dooley of Cabezon Investment Group discussed how he looks at the global economic and financial environment and presented an update to his highly regarded and widely disseminated BWII concept. He argued that the US lives in two worlds from a currency standpoint – a flexible exchange rate system against Europe and Latam and a fixed or managed one against Asia. Bretton Woods II is a way to describe this unofficial hybrid of the former official Bretton Woods currency system. Capital mobility is the key factor in a fixed/managed exchange rate system, he argued, as it serves to alter domestic prices while allowing the nominal exchange rate to remain fixed/stable. It is the critical ingredient that keeps the fixed/managed system alive as capital flows from the surplus Asian countries to the deficit countries.

His current world view suggests that Europe will continue to grow very slowly as there will be no resolution to the current structural problems. This means Europe will turn into a current account surplus region as the whole area becomes more like Germany. The implication is the Euro may be weak in the short term, but should be strong longer term. Meanwhile, Asia remains a surplus region. The financial crisis reduced imbalances largely due to the drop in growth. But, if the US continues to recover, as he expects, then its deficit should grow and imbalances should again begin to widen.

So, when will this system break down? It's been a perennial question. The 2008 financial crisis did not end the system. Many had predicted that such a crisis would prompt a 40% drop in the USD, a spike in US rates and plunge in asset prices. They got everything wrong, said Dooley, except the crisis! All that is testament to the stability of this BWII system and that it seems to work in the interests of both Asia and the US.

What's the end game for BWII, Dooley asked? The answer is simple: when the authorities in the US and/or Asia don't want it anymore. And, the key to watch is financial liberalization in China. There are today powerful groups in China that want to liberalize. If they prevail, then hot money that went into China would run to the exits. The likely policy response would be movement of 1-2trillion USD of reserve assets. This would likely push up US interest rates and the USD vs the Asian currencies. The ensuing discussion centered on the implications of this for volatility, and especially the upward pressure this would likely place on USD/CNY volatility and US T-bond vol (if QE is coming to an end).

Dooley also discussed his positive view of the US economy, and the favorite trade he presented at the Drobny Santa Monica Conference in April which was to buy the US equity risk premium (long SPX vs short 10yr Treasury). Even though the trade has performed exceptionally well already, he thinks there is much more juice given improved household balance sheets and exceptionally low US rates.

2) Jim Leitner of Falcon Investments is one of the great all-time Macro HF investors, and his presentation emphasized his philosophy and advice on trading. 'Be a Fox, not a Hedgehog', he advised, suggesting that it is a mistake to become an expert on one topic. And to look for disconfirming evidence rather than just clinging to what you think is a 'fact'. Always ask what would make your view/position wrong. Instead, he advised being open to lots of ideas and look for ideas everywhere. It is not possible to monitor all markets, asset classes and opportunities. Hence the trick is to create a diversified network of friends that helps you scan the world for opportunities.

The way he operates is to take many independent bets. When you do that, size is a crucial determinant of performance. He sizes on the basis of the Kelly criterion, which helps choose position size both in absolute sense and relative to other trades. His approach is actually more defensive than this; he typically chooses sizes that are ½ that suggested by using Kelly. He notes that when things go wrong, everyone's time horizon shrinks. Sizing positions conservatively allow you to not only hold on to a position when things go wrong, but also leaves room to add in better circumstances.

Leitner used as an example of his trading methodology the idea of receiving 10yr Mexico (10yr TIIE shown below). Yields increased disproportionately compared with Treasuries, the MXN fell, and with inflation coming down, real yields in Mexico now look very attractive in absolute and relative terms. This, he thought, looks an interesting opportunity.

Leitner finished his presentation with something powerful and beautiful. He urged us all to always always think about how we can give back to society!

3) Barry Schachter of Gloria-Mundi LLC was formerly the chief risk manager for Caxton, Moore Capital and others and offered some key guiding principles on risk management which included:

i) only take risks you want to take, don't get suckered into side bets on things;
ii) liquidity is a fickle friend; prepare and plan for potential turbulence;
iii) exiting is the best hedge;
iv) diversification is about risk factors, not positions;
v) don't be dogmatic about views; risk limits are your friend, should be agreed to in advance and always adhered to;
vi) use the concept of marginal risk to build better portfolios;
vii) assess your portfolios in terms of the quality of the revenue stream, not just simple P&L.

Schachter also discussed how stress tests have very limited utility because, by definition, unexpected events can't be properly modeled. Instead, he advocated 'reverse stress testing'…..starting with the question 'how can I make sure I don't lose more than x dollars'? As with Leitner, he warned against 'conformation' bias (getting excited when things go your way), 'availability' bias (attach too much weight to easily available information), and 'recently' bias (attaching too high probability to recent events).

4) Chris Leonard of ARCEM Capital presented some beautiful examples of the precision attached to the way he conducts his trading fixed income markets, using the topic of QE tapering. He started with the concept of paying close attention to ***flows***. Not flows in the usual economic sense of income and expenditure flows; nor in the market sense of who is buying and selling assets. Instead, he urged us to compare all the concentration on QE tapering, which amounts to a total of maybe $500bn per year in Treasuries, with a little noticed change at end of 2012 when the government rolled back depositor insurance at banks, which amounts to maybe $1trn. This created a new incentive for cash to flow from banks to money market funds; he estimated that about $250bn would likely move. Money market funds have durations of a few weeks, bank deposit life is more like 7yrs. This flow could have a substantial effect on the yield curve, and is something that has already started, in contrast with QE tapering that is only anticipated at this stage. The former flow is real and already occurring.

Leonard then turned his attention to a trade combo related to FED policy which consists of buying the US front end while simultaneously playing for a steepener of the money market curve. More specifically, his trade idea is to buy EDZ4 combined with an EDZ5/EDZ6 steepener. The idea is that actual FED tightening will commence later than priced into the market but, as it approaches, a more traditional term premium will be priced into the money market curve.

An important concern with this trade, though, is if credit issues re-emerge, say due to more default issues coming out of Europe. Such an event could precipitate another inversion of the Eurodollar strip. Chris suggested a hedge against his Eurodollar exposure is to buy European swap spreads, which are a good stand-alone trade since the levels are way below levels reached during the periodic European panics. Another potential way to gain credit turbulence insurance, with considerable leverage, is simply to exploit higher US yields and buy low delta calls on US Treasuries.

5) Ajay Jani of Gramercy Capital talked about career moments to motivate a discussion of trading EM markets. As with previous speakers, he noted that 'bad trades will hurt you, but bad sizing will kill you', so he urged all to focus on risk management. He also warned that, especially in volatile EM markets, prices of assets are never 'too cheap', and low prices can move even lower in these markets. So, don't use valuation as a crutch, and always use stops.

Key misperceptions in EM are: (1) all EM are more risky than DM – there are plenty of examples where DM markets are more risky; (2) EM offer higher returns – there are many examples where this also doesn't hold. What makes a good EM risk manager?: (1) good risk management; (2) ability to synthesize politics with economics – politics are much more important in EM and policy makers will always lie when things are going wrong ('There will be no devaluation – that's firm and definite', said Boris Yeltsin just before the 1998 Russia deval!). And, Jani, noted, the best managers in EM have the capacity to imagine the unimaginable.

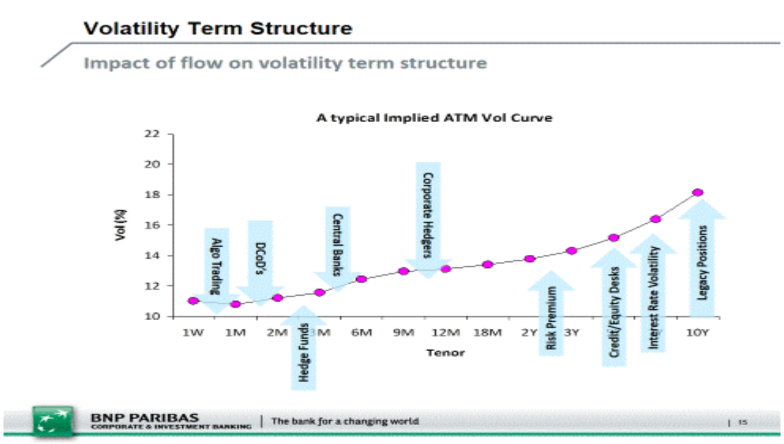
Jani's discussed his current themes. One is that Japan resembles an emerging market….the central bank is buying the debt and devaluing the currency. It's a short FX long NKY trade as long as the central bank keeps participating. A second is that EM equities have underperformed DM for a few years now and look inexpensive both relative and outright. He thus suggested buying the EEM ETF (below), especially since the stop on the position is tight if he is wrong on the trade. The trade fits the idea that

the back up in US yields can pause, allowing EM FX to enjoy at minimum a relief rally and their equity markets to rebound. Ajay admitted, when asked, that his trade presupposed a bounce in Chinese activity.

5) Paul Touradji of Touradji Capital, a well known and highly respected commodity specialist, discussed how commodity markets have changed drastically through his career. The influx of long only money was a game changer in commodity markets and has often resulted in slowing down the effect of fundamental news/facts. As a result, Touradji has had to learn to be more patient than in the past. As an example, commodity markets used to often be driven by a small set of factors; today you have to avoid overplaying the significance of any one variable. And, data is tough to come by, especially on inventories which are a crucial variable in commodity markets.

A good example of all this is in the copper market. The market has been bearish and short copper, largely due to the sharp slowdown in China. Yet the price of copper, although down, has disappointed many bears. And, more disappointments could be on the way. The scrap market for copper accounts for a bulk of copper market activity, yet is a very opaque part of the market. Touradji argued that price dynamics suggest supply/demand conditions are very tight despite market suggestions otherwise. Touradji is thus looking to buy copper, against where most macro participants are positioned/biased, though he hasn't activated the position yet. He is, as he advised, taking his time to put the bet on and showing his new patience.

7) Rodolfo D'Avino of BNP Paribas is an options specialist and presented a neat discussion of the currency options market. He noted that there are many different players driving the market and you need to understand that different flows drive vol in different tenors, as in the picture below.



Options, he argued, are not intrinsically overpriced. In fact, he urged participants to not be afraid of high vol or high premium, instead be alert to regime changes and stick to your own trading style. And, don't be afraid of a high risk reversal. In fact, use risk reversals and study the vol surface to gain information about the market. The risk reversal, he argued, captures the correlation between spot and volatility. As an example, when the risk reversal disconnects from spot/vol, then this is likely indicative of positioning which doesn't allow adjustment to underlying pressures. Additionally, FX vol surfaces invert during periods of stress and this should prove unsustainable, as CB and gamma traders step in to exploit high short dated vol, serving to smooth currency moves and dampening delivered volatility. As a result, he currently favors vol curve steepeners giving exposure to long dated vol while taking advantage of spikes in short dated vol when big moves emerge. The fact that different players are active at different parts of the vol curve allows the HF trader to exploit curve anomalies that emerge.

7) Antulio Bomfim of Macroeconomic Advisors, a FED watcher and FED expert, discussed how the FED operates, its mandate, and how it achieves its goals. He noted how many seem to misunderstand FED operations since there is often a discernable market response to comments made by non-voting members! It is a small circle that actually decides policy, he noted, so those few are who you want to watch and listen to.

The new unconventional policy differs from traditional FED policy in that the latter was aimed solely at the FED FUNDS rate but the new policy has attempted to directly influence rates further out the curve via pulling down the ***term premium.*** He presented various estimates of how much QE and forward guidance have affected longer term rates and flattened both the money market and bond yield curves.

His assessment today is that the market still overestimates the odds of a first rate hike in 2014, which is why he sees value in buying the EDU4 contract. Against this, he suggested selling EDU8 which, at an implied rate of roughly 3.70% (currently at 96.32), is trading decently below where an equilibrium Fed Funds rate is likely to be (say 4-4.5%, building inflation at 2% and real growth at 2-2.5%).

Andres Drobny

****Past reports can be accessed at www.drobnyresearch.com***

(PANEL BIOGRAPHIES OVERLEAF)

PANEL BIOGRAPHIES: BNP Drobny Macro Summer School New York 2013

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Antulio Bomfim ~ Macroeconomic Advisers

Antulio N. Bomfim is a Senior Managing Director at Macroeconomic Advisers and Co-Head of the Monetary Policy Insights (MPI) Service. He joined Macroeconomic Advisers in 2009. Dr. Bomfim analyzes developments in U.S. monetary policy, with a focus on their implications for the fixed-income markets and the economy. From 2003 to 2009, Dr. Bomfim was a Fixed-Income Portfolio Manager and Co-Head of Interest Rate Strategy at OFI Institutional Asset Management, the institutional investments division of OppenheimerFunds, Inc. Dr. Bomfim served for 11 years on the research staff at the Board of Governors of the Federal Reserve System, where he was a Senior Economist at the Division of Monetary Affairs and, earlier, an Economist at the Division of Research and Statistics. He was a frequent author of documents written in preparation for meetings of the Federal Open Market Committee and regularly briefed Members of the Board on financial market developments. Dr. Bomfim is the author of *Understanding Credit Derivatives and Related Instruments*, an award-winning book published in 2004. Dr. Bomfim received his B.A., M.A., and Ph.D. in economics from the University of Maryland at College Park and his M.Sc. in mathematical finance from the University of Oxford, in England.

Rodolfo D'Avino ~ BNP Paribas

Rodolfo D'Avino joined BNP Paribas in 2009, and currently oversees the foreign exchange franchise alpha team - its primary focus the analysis of the macro picture and the quality and quantity of the market flows. D'Avino has extensive experience working with the foreign exchange market and has traded the whole spectrum of FX Derivative products including: vanillas, exotic, complex; g10 and EMK currencies. D'Avino started his career at his career at Banque Paribas, London (1994 – 2001). Prior to re -joining BNP Paribas, he worked for Bear Sterns, as a Senior Managing Director of their foreign exchange options division, where he was responsible for the trading of g10 currency pairs (2001 – 2008). D'Avino received a degree in economics at Pisa University, Italy.

Dr. Mike Dooley ~ Cabezon Capital

Michael Dooley is Chief Economist and Partner at Cabezon Investment Group and Professor of Economics at the University of California, Santa Cruz. He is also a Research Associate of the National Bureau of Economic Research and is a Managing Editor of the International Journal of Finance and Economics. He previously held positions at the Federal Reserve Board's International Division, the Research Department of the International Monetary Fund and Deutsche Bank. His published research covers a wide range of issues in open economy macroeconomics including work on global imbalances, crises in emerging markets, debt restructuring, and capital flight. Professor Dooley received his PhD from Penn State University.

Ajay Jani ~ Gramercy

Mr. Jani is the Portfolio Manager of the Gramercy Emerging Markets Macro Fund and Gramercy Dynamic Equity Fund and Co-Portfolio Manager of the Gramercy Master Fund. He also assists with overall risk management for Gramercy's distressed credit hedge funds. Prior to joining Gramercy in June 2009, Mr. Jani managed the quantitative emerging markets macro strategy for London Diversified Fund Management. From 2005 to 2009, he served as Managing Partner of Single A Capital LLC, an investment advisor focused on Emerging Market Macro investments. At Banque Paribas, Jani was head of the emerging markets external debt trading group in Europe, which included oversight of a profitable client flow business and investing proprietary bank capital in credit instruments. After relocating to New York the mandate expanded to include foreign exchange, interest rates, and equity, in addition to building a proprietary quantitative trading business. Jani was at Banker's Trust International in London where he built a customer flow business and traded over 15 countries. From 1995 to 1998 he worked at Lehman Brothers in New York and London where he specialized in trading emerging markets sovereign debt and was active in several sovereign restructurings including Panama, Peru and Russia. Prior to attending business school, he spent four years at Sanford C. Bernstein in their fixed income trading and research departments where he analyzed and helped manage various U.S. dollar fixed income assets including corporate bonds, mortgages and treasuries. Mr. Jani received a BA in International Economics from the University of California, Los Angeles and a MBA in Finance and International Business from Columbia Business School where he graduated Beta Gamma Sigma.

James Leitner ~ Falcon Family LP
Jim Leitner is the investment manager of Falcon Family Fund. Before founding Falcon, Jim was head of Bankers Trust European Trading and established their Currency Anomaly Fund, which returned 40% per annum under his management. Jim earned a B.A. degree in Economics with a minor in Russian Studies at Yale University. He also has a MA in International Affairs from Columbia and a JD from Fordham Law School.

Christopher Leonard ~ Arcem Capital
Chris Leonard is the founder and CIO of Arcem Capital, a global macro and fixed income hedge fund based in NY that launched in September 2012 and is currently managing $600mm. Prior to Arcem, Chris was a founding partner at Alphadyne Asset Management and lead Portfolio Manager responsible for the Liquid Rates investment strategy. Prior to Alphadyne, Chris spent ten years at JP Morgan, where he ultimately served as Managing Director and Head of the New York Interest Rate Swaps and Options Trading business. He currently serves on the board of Harlem RBI. Chris graduated magna cum laude from Princeton University with a B.S. in Mechanical Engineering.

Barry Schachter ~ Gloria-Mundi
Dr. Schachter contributes to the development of risk analytics at RiXtrema, and is an author and speaker on various risk management topics. He is a Research Associate at EDHEC Risk Institute and a Fellow of the Program in Mathematics in Finance at the Courant Institute of NYU. Between 2000 and 2012, Dr. Schachter led the risk function at several hedge funds, including Caxton, SAC, and Moore. From 1997 to 2000 he was with Chase Manhattan Bank, where, among other things, he worked on risk models. From 1990 through 1996 he worked on derivatives regulation and bank supervision, first at the CFTC and then, at the Comptroller of the Currency. He spent the early part of his career in academia. In 1996 he started Gloria-Mundi, an online resource for risk management research. His most recent book, How I Became a Quant, was co-Edited with Richard Lindsay and published by Wiley in 2007. His risk management blog is BelRanto.tumblr.com. He received his Ph.D. in Economics from Cornell University.

Paul Touradji ~ Touradji Capital
Paul Touradji is the founder and Portfolio Manager of Touradji Capital Management, a New York and Houston based hedge fund specializing in fundamental research and active investment in commodities and commodity-related equities. Paul has over a decade of experience investing in commodities and related equities on the public and private markets. Paul began his commodities career at Tiger Management and it was at Tiger that he developed his fundamental approach to analysis and investment in commodities. Prior to Tiger, Paul's focus was on quantitative arbitrage principally with O'Connor Partners. Paul is a 1993 graduate of the University of Virginia and a CFA.

Andres Drobny ~ Drobny Global Advisors
Andres Drobny is the founder of Drobny Global Advisors, a financial markets research boutique based in Manhattan Beach, California that advises a select group of hedge funds, proprietary traders, and global money managers on world markets. Before starting Drobny Global Advisors, he served as Strategist & Proprietary Trader at Credit Suisse First Boston in London and NY, and was on the Global Foreign Exchange Management Committee. Drobny also served as Chief Economist & Head of Research for Bankers Trust Company, London. Prior to entering the financial markets, Drobny was an academic economist at the Universities of Cambridge & London and holds a PhD in Economics from King's College, Cambridge.

David Berry ~ Drobny Global Advisors
David Berry is a partner and manages the Drobny research and conferences. He joined Drobny in 2004 after serving as an Assistant United States Attorney for the U.S. Attorney's Office in Washington DC. Prior to that, Mr. Berry was an associate attorney at Wilmer, Cutler and Pickering LLP. Mr. Berry started his legal career as a trial attorney at the United States Commodity Futures Trading Commission ("CFTC"). Mr. Berry was detailed to the USAO for the District of NJ as a Special AUSA and was part of a taskforce that successfully investigated and prosecuted a nationwide criminal foreign currency trading enterprise. Mr. Berry holds a JD from Seton Hall University School of Law and a bachelors from the University of Richmond.